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## CURRENCIES AND CREDIT MARKETS

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**"Devaluation only registers (relative) decay by reducing real wages. If the basic weakness of the economy is not remedied, the decline in competitive power is resumed and the monetary problem reappears."**

Unequal Partners, Thomas Balogh
Volume One, p.136, Oxford 1963

## HIGHLIGHTS

The recent currency crisis in Europe is not just another minor tempest within the ERM. It's part of an unfolding global currency crisis — the biggest ever — foreshadowing a deteriorating outlook for the world's chronic deficit countries.

Speculative bubbles are popping everywhere — the Japanese asset inflation, the over-borrowed over-consumption booms of the Anglo and European deficit countries, and the biggest international cross-border lending and borrowing boom in modern financial history.

The scale of the international borrowing binge of the 1980s begs credulity. What made it so much worse is the uses to which the deficit countries put this mountain of debt. This insane chapter of international finance is now coming to an end. We explain why.

Alarmingly, international credit and capital flows have already begun to shrink. We are gravely worried about the implications of that new trend for worldwide financial markets and currencies.

Forecasters still cling to the view that a U.S. recovery will lead and pull the world back to prosperity. In contrast, we see a deepening recession in the United States and a coming recession in Europe.

What we see in many countries is a savage combination of debt crisis, growth crisis and currency crisis. The recuperation process will require years of painful adjustment.

We see growing threats to the overvalued stock and bond markets and currencies of the deficit countries — particularly the U.S., Canada, Britain, and Australia.

The dollar remains under downward pressure against the D-mark and yen. There's just no way of knowing how far it might fall yet. We explain why the dollar is still in the grips of a long-term downtrend.

Debts and deficits have always been the determining factors for currencies and financial markets over the long-run. After a long leave of sanity, we think common-sense fundamentals again rule.

We redouble our long-standing warnings and recommendations to investors. Continue to focus on hard-currency bonds — the top-quality government bonds of Germany and Switzerland.

## A GLOBAL IMPLOSION

Treacherous monetary and currency crises are erupting everywhere — Europe, Scandinavia, the U.S., Canada, and Australia — inflicting serious damage to unwary investors. A major one that has bubbled over recently is in Europe. At long last, the monetary volcano that's been boiling up steam and pressure for years has erupted . . . explosively! It was only a matter of time before the European regime of semi-fixed exchange rates, called the European Monetary System (EMS), would spew currency devaluations and destructive financial fallout. Since the time of our last letter, the British pound, the Italian lira, and the Spanish peseta have been the major currencies that have caved into sizable devaluations — more than 15% in the case of the lira and pound sterling. Before anything else, it's a topic we need to discuss. It is symptomatic of dire world conditions and has implications for investors everywhere.

## THE REAL ROOTS OF THE EMS CRISIS . . .

Now that the EMS is near tatters, howling policy-makers are seeking a scapegoat. Rather than looking within, they're pinning the blame on the German Bundesbank, the speculators, the media . . . anybody. Speculators may have been the final straw that broke the camel's back, but the true cause of the blow-up is a long-running cumulation of stresses. In this case, it was caused by the persistent imbalances of budget deficits, current-account deficits and the related impact of widely diverging inflation performances. Governments refused to deal with these issues; international investors ignored them and carelessly financed these deficits with reckless abandon.

As we have persistently warned and explained, there was neither true discipline nor virtue in the EMS system, which, instituted in 1979, governed the movements of European currencies through the application of the European Rate Mechanism (ERM). Given the limited trading ranges of the European currencies relative to each other—some like the D-mark and the French franc were allowed to fluctuate in a range of plus or minus 2.25%, others such as the British pound and the Spanish peseta were allowed a 6% range—investors began to assume that currency risk no longer existed. As a result, money piled into the currencies with the highest interest rates — naturally meaning those currencies with the highest inflation rates. The net result was that the countries with the poorest fundamentals, those with huge deficits and high inflation rates, attracted foreign investment and paradoxically ended up with the strongest currencies while the lower-yielding, fundamentally-strong currencies ended up as the weaker ones. This kind of currency system is totally perverse and therefore was destined for an inevitable blow-up.

Upon closer inspection of the EMS, one realizes that the stability of this system — the fact that the fundamentally weak currencies didn't fall from grace earlier — was due to nothing less than a huge speculative bubble. As with all such bubbles, ultimate doom was only a question of time.

## . . . AND BUNGLING POLITICIANS

Ironically, it was the Maastricht treaty of all things — the timetable that Europe adopted to move to a single currency by the end of the decade — that precipitated the collapse of the ERM bubble. By unilaterally adopting this treaty, it became evident that Europe's unpopular and incompetent politicians — the so-called Eurocrats who populate the federated government of the European Community — had grossly miscalculated public opinion in their home countries. Rarely have politicians in Europe ever been held in such low esteem.

The Maastricht bungling isn't the whole of it. Contributing to this general contempt, certainly in Germany as well as elsewhere, is the appalling apathy of these Eurocrats toward other important issues such as Yugoslavia where a horrible civil war between the Bosnians and the Serbs has broken out replete with the worst human atrocities imaginable. History has condemned Britain's Prime Minister Chamberlain, when back in the late 1930s, he caved in to Hitler. Today, the leaders of the whole Western world bow to the military nobodies of the Serbian side of the Yugoslavian war. Even worse, the West is indirectly supporting the Serbs by keeping the Bosnians defenceless with a common weapons embargo. The Serbs virtually have been handed a licence to kill Bosnians indiscriminately — men, women and children. Ever since Hitler, Europe has not seen such perfidious politicians. To think of them as the builders of a new Europe is simply repugnant.

Back to the financial side of Europe's woes (we couldn't resist taking a swipe at the Eurocrats). For us, the handwriting on the wall has been clearly visible for a long time. In our last letter, which analyzed and described the insanity of this ERM bubble, we warned, "*that the day of reckoning for the currency markets — particularly for the currencies of the capital-importing countries whether in Europe or elsewhere — will come when their economies weaken and domestic policies begin to clash increasingly with external requirements*." On this matter and many others, we have been a lonely voice in the wilderness with these warnings for a long time.

## CONTINUING PROBLEMS

For many politicians and commentators, Europe's economic and currency woes have one main villain — the Bundesbank. It's alleged that its parochial, high-interest rate policy prevented other countries from easing their interest rates in response to their weakening domestic economies and therefore caused the current crisis. Yes, Germany's high interest rates were an aggravating factor, but the true cause of Europe's currency troubles is a debt and growth crisis which the governments of the weak countries themselves have wrought through their bad policies. Everything else — high interest rates, German unification — came at a time when the economic structures of the deficit European-member countries were already weakened and vulnerable. It's arguable that lower interest wouldn't have helped the deficit countries much anyway. After all, why are Japan, Canada, Australia and the U.S. still stuck in recession-like conditions despite sharply lower interest rates?

Germany, no doubt, will slowly and cautiously lower its interest rates in coming months. Yet, even so, these moves will not return Europe back to its former status quo when economic and financial equilibrium rested heavily on permanently high capital outflows from Germany. For one, the astronomic bill for German unification, running to about DM 200 billion or about 6% of west German GNP, has profoundly upset Europe's former regime and will continue to do so for some time. Having been a large net capital exporter, equivalent to about 3% of GNP, Germany has instead become a net capital importer (1/2% of GNP in 1991). Unification essentially turned the strong D-mark from a low-yielding currency into a high-yielding one thereby reversing Germany's capital account. That and not necessarily high interest rates is the enduring new problem for Europe and the world . . . in other words, no more luxuriant supply of capital from Germany to rely on.

## FAR-REACHING IMPLICATIONS FOR WORLD MARKETS

The present currency crisis is more serious than any previous one — much more serious than anybody has forecasted — because it hits a vulnerable world economy that's fraught with a vulnerable international financial system. We are very worried about its highly adverse implications for many reasons: firstly, for

international credit and capital flows; secondly, for the currencies of the deficit countries in general; thirdly, for financial markets; and fourthly, for economic and monetary policies.

As highly as we admire the credibility and hard-money policies of the Bundesbank, there was one point in which the Bundesbank was seriously mistaken: It grossly underestimated the fragility and progressive weakening of the world economy. How come? With some irony, we think, it is because they listened too much to the upbeat forecasts of the economists of other governments, central banks and international organizations like the International Monetary Fund (IMF) and the Organization for Economic Cooperation and Development (OECD). None of them sounded the alarm on a deepening world recession. Instead, they all continued to roll out soothing forecasts of a return to world growth and prosperity. Private economists were no better. They all beguiled each other and the policymakers into false optimism and into overly tight policies. In fact, these consensus forecasts were worse than useless because policymakers actually relied on them.

Reading the latest OECD Economic Outlook from last June, which was written in full knowledge of the German interest-rate dilemma, fully confirms our point. In the report everything seems sunshine and roses. For example, we read that the U.S. is on the verge of leading a world economic recovery and that real U.S. GNP would grow by 3.7% already by the second half of 1992.

There was one short, fleeting chance to mitigate the rise in German inflation and interest rates. It would have required an early upward revaluation of the D-mark by agreeing to allow the D-mark to appreciate above its range against all the other currencies in the ERM. By doing that, Germany wouldn't have needed to raise its interest rates so much. A higher currency in that case would have slowed down the German economy by way of squeezing exports and serving to quicken the other European economies through higher German imports.

## UNDERMINING THE CURRENCY SYSTEM

Both the French franc and the British pound have a long history of devaluing their currencies, a habit they've been trying to kick in recent years. As we write, the pound is trading at a decimated 2.45 D-marks. It may be hard to believe, but in the 1960s the pound was worth 12 D-marks. Just to think that eight weeks ago, Britain's Prime Minister Major made headlines in the press with the declaration that the pound would replace the D-mark as the hardest and most trusted currency in Europe. Since the time of that braggadocio, the pound has already fallen more than 15%. Although the history of the French franc is checkered as well, it's only fair to point out that the French economy has performed very respectably during the five years since the time of its last devaluation in 1987.

When the British first joined the EMS in 1989, the truth of the matter was that their policymakers saw the ERM as a wonderful panacea to their troubles. They were quite open about their reasons for doing so. The expectation was that by linking the pound to the coat tails of the stable Bundesbank, it would lessen the cost of fighting inflation. Entering the ERM with considerably higher interest rates than Germany, Britain hoped to attract foreign capital, boosting the pound, which in turn would allow them to slash their interest rates. It was really seen as a soft option.

Initially, the British achieved precisely what they wanted from the EMS. But, nothing is free. In the end, the price of lower interest rates came in the form of a soaring trade deficit, which, in the long run served to undermine the very objectives of their policy in the first place. It's hard to argue otherwise: Britain entered the ERM for the wrong reasons, at the wrong rate and at the wrong time.

In the midst of the recent currency turmoils, Britain announced the biggest current-account deficit in two years. Just how sick Britain's trade performance has become can best be gauged from the volume figures. During the last three months, export volumes, excluding oil, were up 0.5% while imports rose 7.5%. Already, the U.K. current-account deficit for the first eight months of the year of £7.8 billion ($19.1 billion) surpasses the officially projected deficit for the whole year of £6.5 billion ($15.9 billion). With the U.K. economy in its worst recession since the 1930s, such a sharp rise in its trade deficit is truly frightening. With a dismal performance like that, how can anyone blame speculators, the Bundesbank, or anyone else for the disastrous performance of the pound sterling?

## WHAT PRECEDES THE FALL

We've presented the U.K. situation in greater detail in order to stress the causal connection between economic weakness and a currency crisis. Why is it so significant? Because it has application to the "dollar trio" — the U.S., Canada and Australia. Simply put, countries aren't vulnerable to a currency crisis when their economies are strong. The pound sterling crisis originates in the fact that the U.K. economy is in the most parlous and weakest condition worldwide. The decisive element in the crisis, in our view, was the general realization that no economic recovery was foreseeable in the U.K.. The markets smelled blood when they realized that a high interest rate strategy was unsustainable under such miserable conditions.

In Britain, as in many other countries, this recession is rooted in the enormous real and financial maladjustments which developed during the previous inflationary boom. Britain appears to be the worst case among all the "bubble" economies. Real gross national production (GNP) has fallen by 3% since 1990. (The recession is now in its ninth quarter!) Manufacturing output is below the level of 1974 and manufacturing investment below levels last reached in 1970. Canada is close behind. Manufacturing output is at the lowest since 1978 and its chronic current account deficit continues unabated at 4.7% of GNP. Notably, the Canadian dollar has already fallen 10% from its high against the U.S. dollar. Australia is no better either. Though its economy has picked up mildly, the current account deficit continues near 4% of GNP, a level which has been seen off and on for the last two decades.

As is to be expected, the European currency upheavals have had ripple effects across the globe. While the dollar rallied against Europe, the Japanese yen rallied against the dollar to new all-time highs. These are typical knee-jerk reactions. What's far more important, of course, are the longer-term implications of these currency convulsions for Europe and the rest of the world, especially for America.

## THE ANATOMY OF AN INTERNATIONAL CRISIS

Before the European currency tremors struck, economic growth forecasts for Europe had generally been revised downward. But hardly anyone seriously considered the possibility of recession. Ironically, the main source of the prevailing optimism, both among policymakers and economists, was the conviction that the U.S. economy was ready for a cyclical upturn thus leading a world recovery and pulling Europe along. Even now, forecasters still cling to this view. It's a view we've never shared. In contrast, we see a deepening recession in the United States and a coming recession in Europe.

In past letters we have analyzed the domestic conditions in the debtor and deficit countries emphasizing credit and debt, particularly in the United States. The currency turmoils in Europe prompt new thoughts about the international arena of debt and credit creation — the cross-border flows of credit and debt. There, too, we see the signs that international credit is rapidly drying up. We ask ourselves what this implies both

for the world economy and the world's currencies, not only for Europe but worldwide.

First, one has to realize that an unprecedented credit creation took place through the Euro-markets (the formless, unregulated credit market that exists outside the reach of national central banks) which played a key role in fuelling and fostering the global financial boom in the 1980s, thereby contributing to soaring government deficits, rampant asset price inflation and exploding trade imbalances. It's another bubble that's been pricked, first by Japan's central bank and more recently by the German Bundesbank.

## THE OLD CURRENCY REGIME

Apparently, it's almost forgotten that for the entire postwar period to the late 1970s, deficit countries were more usually threatened by capital outflows. Money fled from countries with deficits to the safety of the surplus countries. As a result, capital flows tended to compound deficit problems and therefore restrict current-account imbalances rather than offset and facilitate them. When the British pound was first devalued in 1967, Britain had an annual current-account deficit of only £800 million. Today, it's 15 times as high. And, in the case of the United States in those days, even minor deteriorations in the monthly trade balance of only a few hundred million dollars tended to trigger a flight of capital and a dollar crisis.

In short, currency movements were guided by the movements in the trade balance. Capital flows created the curative process by which no country — not even the United States — was able to run persistently large current-account deficits. In this way, currency markets exerted a strong disciplinary influence on governments and central banks.

That all went out the window beginning in the 1970s, and most spectacularly so, in the 1980s. All of a sudden the financial and currency markets acquired an imperturbable tolerance to current-account deficits. Any concerns about economic and financial soundness vanished in the single-minded search for higher nominal interest rates. As a result, international credit and capital flows boomed, allowing and fostering international imbalances of unprecedented magnitude.

## A NEW ERA: DISCIPLINES AND CURRENCIES GO AWRY

The crazy state of affairs in global credit and currency markets really got under way with Reaganomics. U.S. economic policies stunned the world with the unprecedented co-existence of soaring budget and trade deficits and even faster rising capital inflows which caused the dollar to rise to dizzying heights.

More than anything else, it was this extraordinary experience that hatched the new theory that budget and current-account deficits of whatever size didn't matter any more for currencies because international lenders and investors were more than eager to finance them. As we have come to observe, there's no brand of economist more adept at dreaming up crackpot theories to suit their business and their profit motives than financial economists, particularly the international breed.

What really happened was that a rampant international credit inflation was superimposed on top of runaway domestic credit inflations through the rapid expansion of the Euro-markets. It was this international credit bubble that generated the excess international liquidity that allowed the deficit countries to inflate their domestic money and credit supply even though they had chronically sick current account deficits. As we've said before, this international boom just gave the deficit countries a longer rope with which to hang themselves.

# A Dire Economic Warning From a German Cassandra

## Global View

By George Melloan

America's economy is wallowing like a ship with little headway in a heavy sea. Britain can't pull out of a long-running recession. Germans are mulling bizarre schemes to finance the huge costs of reunification. Japan's Kiichi Miyazawa's bank bailout scheme bears a shocking resemblance to Nick Brady's money-eating Resolution Trust Corp. of 1989.

These signs of distress have made voters anxious. The French, in a sour mood, threaten to scuttle the EC's Maastricht treaty next weekend. Americans may throw out George Bush even without any evidence that Bill Clinton has an economic policy.

Economists are puzzled. Why has the Federal Reserve been unable to stimulate the U.S. economy with its discount window giveaway? Why are the Japanese launching a massive $86 billion economic rescue program and hinting nervously that they might do even more?

One of the most interesting—but disquieting – answers to these puzzles comes from Kurt Richebacher, a former German banker who edits a newsletter published in Castor Centre, Ont. called "Currencies and Credit Markets." Economists get paid for standing beside the road in reflective orange jackets, waving lanterns to warn of bridge washouts ahead. Dr. Richebacher is waving his lantern furiously.

If you don't believe that, read the first two sentences of his September newsletter: "The world economy is in the worst recession and financial crisis since the 1930s. The most ominous symptom is a worldwide collapse in private credit and broad money growth."

He offers comparisons between today's world economy and the world of 1920-30. "Not only are the parallels strong, the comparisons make the 1920s look like a tea party," he writes.

Dr. Richebacher is a monetarist but contrasts his "Austrian school" analysis of the causes of the Great Depression with the "American school" of Milton Friedman. Whereas Friedmanites cite monetary contraction as the principle cause, Dr. Richebacher lays heavy stress on the "bubble" created by the credit excesses of the 1920s. "Very few people seem to realize that the offending financial excesses of the 1980s—mainly debt orgies stimulated by asset inflation—were virtually the mirror image of the boom-time excesses of the 1920s."

This sounds a lot like the "Decade of Greed" theology America's Democratic liberals are preaching in their efforts to discredit Ronald Reagan. But since Dr. Richebacher makes no distinction between public and private sector excesses, the parallel only works if you believe that the Democrat-controlled Congress was just as greedy as, say, the junk bond kings or the householders who leveraged themselves to the hilt with home equity loans.

But back to the parallels. "The debt and leverage excesses of the 1980s by far surpass those of the 1920s," Dr. Richebacher writes. In the U.S. stock market, today's share prices of 29 times earnings compare with only 18 times earnings in 1929. Although 9,000 banks failed between 1930 and 1933, almost all were country banks and the total losses by depositors were only 3% of total bank deposits. Today U.S. bailout officials are estimating total deposit losses at $500 billion. "That figure equals about 15% of total deposits – more than five times the destruction of the entire Depression!"

The view that the bailouts solve the problem ignores how bank failures contract the supply of money and credit. "In the case of the bailouts, the government replaces the lost deposits with money it borrows and thereby withdraws from the markets . . . the slump in real estate values generally devastates balance sheets of both debtors and their banks. It's only the depositors that are bailed out, and not the system."

He notes that in the 1920s, Germany was the one big debtor country, whereas today the U.S., Britain, Canada, Australia, Spain and Italy are all "hooked on an uninterrupted diet of large capital flows." Japan and Germany are the big creditors.

> *'The world economy is in the worst recession and financial crisis since the 1930s.'*

Yet, Japan itself has proved to be a "bubble" economy. "It is the one and only country with both a budget and a current-account surplus . . . and a very large one at that. In this respect, Japan's position resembles the position of the United States in the 1920s. Those features didn't prevent the collapse of the U.S. economy then. Recently, economic data on Japan has turned outright gloomy."

Indeed it has, which is why Japan's concern about the current state of its banks should be worrisome to the world at large. If Japan ceases to be the world's big credit cow and Germany continues to struggle with the problem of financing reunification, who exactly will be available to finance the $350 billion deficit the U.S. Congress is currently running? More to the point, who will finance any U.S. recovery at a time when the federal government is gobbling up most of the credit?

Dr. Richebacher is concerned about the complacency of monetary policy makers. In a separate, highly technical paper he sent me for review, he challenges Alan Greenspan's explanation that the money sluggishness is caused by money flowing out of bank accounts, where interest rates are low, into mutual funds and securities. "To attribute persistent, extremely weak money growth to the slashing of interest rates, as the Fed does, is surely the most revolutionary idea in monetary theory and history." He argues that although money flowing into securities fuels the securities markets, this has no effect on money supply, simply because these investments merely pass from one bank account to another.

The crippled U.S. credit machinery is really the cause of the money growth weakness, he argues. "In 1988, banks and thrifts expanded their balance sheets by $270 billion. Last year, they shrank by $60 billion. . . . It goes without saying that this implies a parallel credit contraction." He throws cold water on the Fed's hopes that the depressive effects of slow money growth will be offset by greater use of the existing money supply, what economists call "velocity." Not given the current state of the credit machinery, he asserts.

What is the remedy? Returning to Dr. Richebacher's newsletter in hope of finding one, one reads a depressing conclusion: "We doubt that governments and central banks can do very much about the deepening worldwide economic and financial crisis, even if they knew better. The grave trouble is that they don't know better. Just as they never understood the sinister workings of asset inflation in the first place, they can't be expected to understand the wideapread implications of asset deflation either."

If all this sounds depressing, keep in mind that for years economics has been called the "dismal science." On the other hand, there is a worldwide asset deflation underway and the U.S. dollar is excessively weak. So I thought you should hear what Dr. Richebacher has to say.

## THE INTERNATIONAL CREDIT BUBBLE

**LENDING IN INTERNATIONAL MARKETS: 1987-1991**
**$ Billion**

| | 1987 | 1988 | 1989 | 1990 | 1991 |
|---|---|---|---|---|---|
| International Bank Lending | | | | | |
| Gross | 760 | 511 | 807 | 714 | -102 |
| Net | 300 | 260 | 410 | 465 | 85 |
| Bond Issues | | | | | |
| Gross | 176 | 227 | 167 | 263 | 329 |
| Net (less redemptions) | 105 | 148 | 177 | 154 | 181 |
| Net Euro Note Placements | 23 | 20 | 7 | 32 | 34 |
| Total International Finance | 428 | 428 | 594 | 651 | 300 |
| Less Double Counting | 53 | 67 | 76 | 79 | 35 |
| Total Net Int'l. Financing | 375 | 361 | 518 | 572 | 265 |

Source: Bank of England, Quarterly Bulletin, May 1992, p. 190

The neighbouring figures give an idea of just how large the international credit bubble was. Between 1980 and 1991, the stock of "international" bank lending (i.e. cross-border lending plus domestic lending in foreign currency) rose from $324 billion or 4% of the combined gross domestic product (GDP) of the 24 OECD countries to $17.1 trillion or 44% of the OECD's total GDP. (Source: Bank of International Settlements as quoted in the Economist, London, September 19-25th, 1992, Survey p.9). If this cross-border frenzy hadn't already happened, we'd say it's simply unbelievable. Why not focus on the net figures rather than the gross figures as we have? Because, to our way of thinking, the gross figures tell the whole story since it is always the total borrowing and lending between countries, not the net differences between them, that determines the extent of the credit and money creation. Ominously, the thing to note is that this international activity has already begun to decline as of late 1991.

The scale of this international borrowing and lending binge begs credulity. It's unprecedented in the annals of modern financial history. Previous global booms in cross-border flows pale by comparison. But what made it all so very much worse is the uses to which the deficit countries did put this mountain of borrowed money. Most of the money was wasted in financing government deficits, malinvestments in real estate and in fuelling the worldwide asset price inflation which propelled the rise of private consumption at the expense of investment.

Within this international credit bubble, there's one phenomenon that requires special attention: the Euro-credit bubble that was "made in Japan." Although we've commented on it often, Japan played a key role in spreading asset price inflation to the rest of the world. Now, it's rapid credit contraction is spreading asset deflation.

From 1984 to 1990, Japanese institutions in aggregate spent the equivalent of almost $1 trillion on the purchase of foreign assets, mostly in the U.S. Only $400 billion of this awesome sum was funded from Japan's current account surplus (meaning Japanese savings). The other $600 billion or so was financed through international credit creation by borrowing in the Euro-markets. All of this has been reversing; these borrowings are now being repaid. What that implies is shrinking international credit and downward pressure on the world's asset markets, specifically those of the United States.

Lamentably, very little of the capital inflows went into new productive investment. If it would have, the global lending and borrowing binge may not have been so bad. At least productive investments would have generated income and economic growth to repay the debts. The global cross-border credit boom of early 1900 to 1915 had that element going for it. No major disasters were therefore attributed to this boom. This time though, the Anglo countries have battered their industrial base to such an extent by wasting the

borrowed money on non-income producing things, that they now are experiencing sharply rising trade deficits in the midst of recession. What a mess! Just like the domestic credit inflations in each of the respective deficit countries, the international credit flows fostered a massive misallocation of resources and left behind a rubble of weakened and highly vulnerable economies.

To be sure, our opinion that the large international credit and capital flows have done more to ruin the economies of the deficit countries than strengthen them, applies to all of them no matter what currency system they may practice, whether semi-fixed as in the ERM or free-floating. It was similar in the case with the lesser developed countries (LDC's) during the 1970s, in Austria and Germany through the 1920-1930s global capital flow boom, and now in the deficit countries in Europe with semi-fixed exchange rates — Britain, Italy, Spain, Scandinavia, to name the major ones — and the Anglo deficit countries with floating currencies — U.S., Canada, Australia and New Zealand.

## THE ERM CRISIS VERSUS THE DOLLAR CRISIS

The currency upheavals in Europe have brought forth a spate of gloomy reports pointing to the chaotic situation in Europe. Temporarily, attention to the economic gloom in North America has been distracted. During the crisis, the dollar was once again hailed as the one and only "safe haven" in a sea of global instability. We find that very odd. The truth is that the U.S. dollar has suffered an even bigger devaluation against the D-mark than even the worst of the currencies in Europe. (See graph on the opposite page.)

But the dollar's slump hasn't suffered nearly the public recriminations that the ERM devaluations have. Why is that? We see two reasons: firstly, because the dollar floats against the D-mark, its decline is simply not perceived as a currency crisis. Even more important, the markets are still crowded with long-term dollar bulls betting on its supposed undervaluation and its safe-haven appeal. To this camp of bulls, the large DM/$ interest rate gap is only a temporary constraint on the dollar. As soon as it vanishes, as it inevitably must, the dollar will soar they think. Meanwhile, these bulls have suffered heavy losses, both on the currency and the lost opportunity for higher interest income. For now, their conviction remains strong although they're surely becoming very uncomfortable.

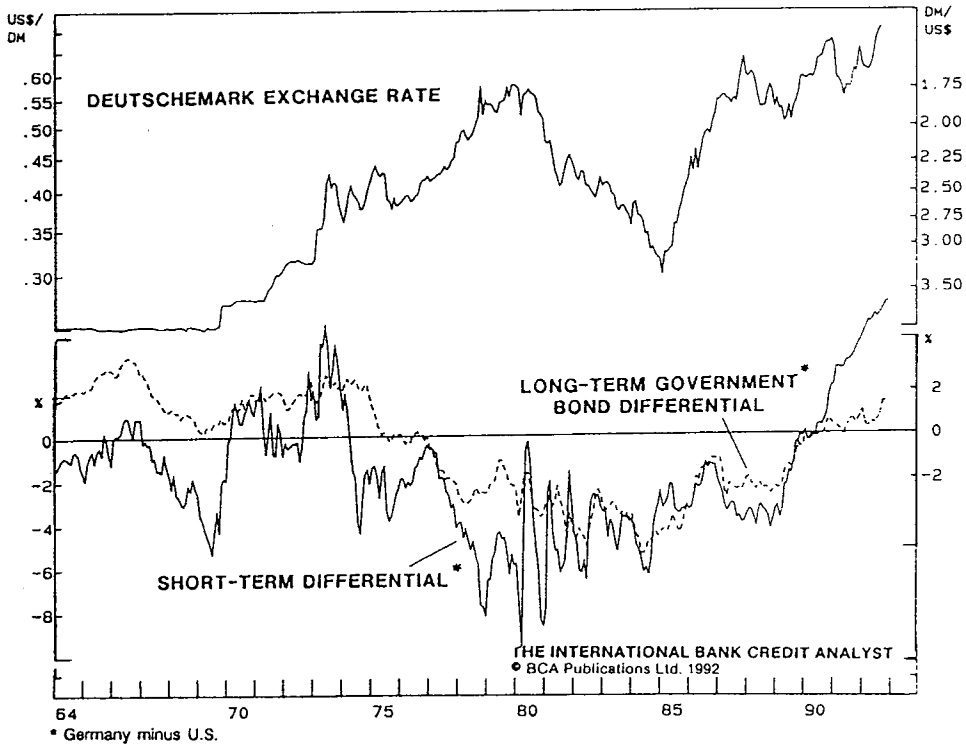
## A RETURN TO BASICS

Before long, the recent currency upheavals will be forgotten. Then, markets will again focus on the relative prospects for economic growth and interest rates between North America and Europe.

When the EMS crisis unfolded, the Bundesbank made a minor reduction in its interest rates in exchange for the devaluation of the Lira. The first reaction of some stock markets was elation on the expectation that a further monetary easing was likely after the realignments. Wall Street was quick to conclude that lower European interest rates would give the limping U.S. economy a boost later this year. Since, though, markets have quickly sobered. Indeed, while devaluations are sometimes necessary and inevitable, they are no panacea. On the contrary, they hurt.

According to the Anglo brand of economics, devaluations spell easier money and a "dash for growth". Contrastingly, the German/Austrian school of economics has a different perspective. To them, tighter money is necessary to remove existing trade deficits and to contain inflation. Over the intermediate to long-run, the Anglo approach has been wanting; inflation, currency devaluations and deficits have been incessant and economic growth has actually diminished. Hopes that the European countries are free to press the monetary accelerator, now that they have shucked off the restraints of the ERM, are illusive.

US DOLLAR VS D-MARK




Source: International Bank Credit Analyst

Interestingly, nobody ever mentions the enormous policy problems that will arise for the deficit countries due to their existing huge foreign debt overhangs and current-account deficits. The first thing to see is that such deficits tend to rise after devaluations, owing to rising import prices. Given the great, new exchange rate uncertainties and a sharply lower global credit supply, debtors will find it much more difficult to finance their deficits than it was during the 1980s when the world credit markets were awash with liquidity. Debts and deficits used to be highly negative factors for currencies. Now as sanity and a new respect for risk returns to markets, these factors will again take on crucial importance. In this light, currency risks haven't declined; they've risen sharply.

## MORE CRISES TO COME

This is not just another minor currency tempest as has happened many times in the past. It's part of an unfolding global currency crisis — the biggest ever. At its very root is a savage combination of debt crisis, growth crisis and currency crisis. It's exactly what happened to the LDCs ten years ago, after they had flagrantly misused their excessive borrowings. Unfortunately, neither governments nor bankers nor markets learned their lesson.

Essentially, the currency upheavals in Europe raise new questions about the U.S. dollar. A veritable "dollar crisis," to be sure, would send U.S. bonds and stocks crashing as it did in 1987, especially so considering the inflated stock prices in the U.S. The way we see it, the dollar remains under continuing downward pressure both against the D-mark and the yen. What, though, would turn a "benign" decline into a "malign" crisis? The short answer: panic.

Most astonishing is the widespread belief that a monetary easing will quickly revive Europe's economies. Haven't sharply lower rates so far completely failed to produce significant recoveries in debt-ridden

America, Canada and Japan? Why should any interest rate cut do anything different in the case of Britain and Scandinavia where the debt problems and the structural deformations depressing the economy are among the worst in the world and where the room for such cuts is very limited?

## THE DOLLAR OUTLOOK

Essentially, the currency upheavals in Europe raise new questions about the U.S. dollar. The token interest rate cut by the Bundesbank stimulated a brief dollar rally which, however, quickly gave way to a new decline. There is no way to say how deep the dollar can still fall. As we said before, one thing is clear: the dollar remains under downward pressure both against the D-mark and yen. It has always been our view that this dollar weakness mainly reflected U.S. economic weakness not only on a short-term cyclical basis but also from a long-term secular perspective.

Our long-term dollar pessimism arises from our long-held view that the present U.S. recession is not just a simple cyclical phenomenon. It's a debt and growth crisis that implies many years of economic and financial re-adjustment. In this view, the U.S. economy has entered a long period of economic stagnation, meaning that interest rates must remain at low, internationally unattractive levels. The implication is a chronically weak dollar for a long time to come.

Yet, the U.S. dollar's long-term downtrend has unfolded with sharp swings. The surest short-term influence behind these movements has been the U.S. business cycle. In general, the dollar has always gained against the D-mark when the U.S. economy pulled out of recession sooner or faster than Europe. Apparently, this has become such an ingrained tenet of conventional wisdom that dollar rallies are now driven purely by the expectation of a U.S. economic recovery. The temporary dollar rebounds of early last year and this year were mainly driven by euphoric forecasts of an imminent U.S. economic recovery. Markets were expecting a sharp narrowing of the interest rate differentials between Germany and the U.S. Disputing these forecasts and expecting a deepening U.S. recession, though, we remained bearish on the dollar.

Europe is heading for a recession. Of course, bulls consider this bullish for the dollar since Germany and other European countries will be forced to reduce their interest rates. To the contrary, we think, it will be bearish for the dollar. Why? Firstly, a European recession will add to U.S. economic weakness by retarding U.S. exports. Secondly, for well-known reasons, Germany will be very slow in cutting its interest rates. Thirdly, if the extremely weak economic data in the U.S. means anything recently, the U.S. economy itself is on the brink of a fresh economic downturn — a so-called triple dip. In our view, there are three main forces that threaten to trigger a looming dollar crisis:

1. Growing disappointment over the U.S. economy's failure to stage a normal recovery and the corresponding need to keep interest rates at low, internationally uncompetitive levels.
2. Despite its deepening recession, America is still heavily dependent on continued high, if not rising, capital inflows to finance a large current-account deficit and increasing capital outflows (U.S. investors diversifying into foreign investments, Japanese repatriations . . . etc.)
3. Increasing difficulty to meet these external capital requirements as the availability of international finance is rapidly shrinking.

As we've pointed out, it had become a complacent notion in the markets that existing current-account deficits were sustainable indefinitely. This foolish belief lured a stampede of international investors into Europe's high-yielding currencies. The sudden collapse of these currencies caught investors completely unawares, inflicting losses of 30% and more. What was forgotten, too, was that currency crashes generally

take down the respective stock and bond markets as well.

But back to the U.S. Given that the U.S. dollar is the world's key currency, many people think that the U.S. financial markets are immune to a currency crisis. Apparently, they have completely forgotten the 1987 drama when the U.S. dollar, bond and stocks went into a tailspin all together and culminated in the 1987 stock market crash.

What actually did trigger the stock market crash? It was two things. The first tremors of instability were triggered by a very bad figure on the U.S. trade deficit. But the final fuse that blacked out the stock market came from Mr. James Baker (at that time the U.S. Treasury Secretary) who made a sharp attack on the Bundesbank's famous hawk, Mr. Schlesinger, with the threat that the dollar be allowed to fall further.

Actually, the dollar had been sliding against a background of sharply rising interest rates already. As international investors increasingly became wary of a rising U.S. trade deficit that would depress the dollar, U.S. capital inflows slowed very sharply causing long-term rates to rise and the dollar to fall.

The worst was averted when foreign central banks stepped in to rescue the dollar with massive interventions in the currency markets. By stabilizing the dollar, financial markets were quieted. Purchases by the Japanese central bank were the largest, but unfortunately they laid the basis for the subsequent stock and land price explosion in Japan.

Can the drama of 1987 replay again in a similar way? What's the difference between then and today? One thing is better today — everything else is much worse. The only thing that appears to be better is the U.S. trade deficit. In 1987, the U.S. current-account deficit was $163 billion. Today, it's running about half that size at $80 billion. But smaller as it is, this deficit still appears alarmingly high when seen against the background of a prolonged U.S. recession and a sharply lower supply of global credit. The most obvious negatives for the dollar, on the other hand, are the current GNP growth and interest rate differentials. In 1987, when real GNP growth in the United States was 3.1% (Germany's growth was only 1.7%) the dollar enjoyed an interest rate advantage of 2.5% to 3% over the D-mark. And even then, U.S. capital inflows slowed sharply.

The most important difference between 1987 and today is in the world economic situation. Then, the world economy was on the verge of a boom, now it's on the slippery edge of a recession. This time the D-mark has a big interest rate advantage. Though this large differential (still over 6 percentage points) is sure to narrow over time, it will stay large over the long-run since on the U.S. side a persisting debt and growth crisis will necessitate exceptionally low interest rates. What's more, all U.S. asset markets are unattractive as never before given record-low interest rates, grossly inflated stock prices and a savage real estate crisis. Not surprisingly, the U.S. capital account is deeply in the red already since early 1990.

What can support the dollar? Well, during the last two years, whenever the dollar rose, it got its main support from short-term investors betting on a rally driven by recovery expectations and emboldened by the dollar's alleged undervaluation. But this time, as these expectations begin to crack, there won't be any more supportive speculators. That leaves us with the question of central bank intervention, the great fear of many traders. We think that after the currency upheavals in Europe, which involved currency interventions of an astronomical size, any new support operations for the dollar would be virtually impossible. In the battle for the survival of Europe's ERM, the Bundesbank alone bought DM 92 billion ($65 billion) worth of foreign currencies. The total resulting losses for all of the central banks is estimated at between $20 to $30 billion. After such a global monetary bloodbath, we can only conclude that the world currency system is in tatters.

## CONCLUSIONS

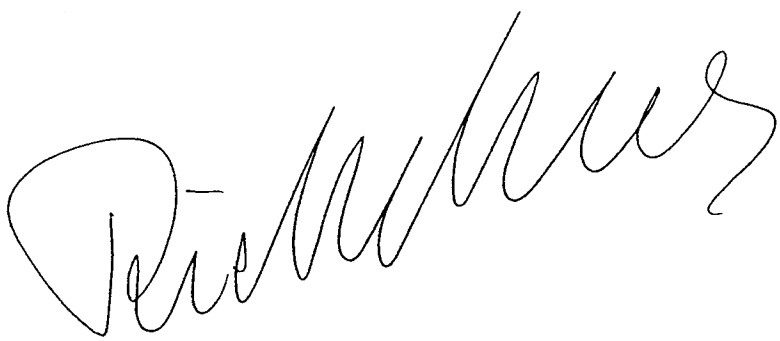
The world economy is suffocating under the excessive debts — both domestic and external — piled up during the free-wheeling 1980s. Europe's recent currency crisis shows just what happens to the vulnerable deficit countries. Their currencies were battered savagely; confidence in their economies evaporated suddenly. Literally overnight, their current-account deficits could not be financed any longer and their currencies were pulled into a free-fall.

The debts and deficits that give rise to these upheavals don't just disappear when currencies are devalued or floated. Quite to the contrary, foreign borrowing becomes harder. Given the jittery currency markets and the much tougher global lending environment, the troubles of the debtor and deficit countries can only deepen.

The worst thing yet to happen is a dollar crisis that will involve the U.S. bond and stock markets. Essentially, every crisis is always a confidence crisis. So far, the conventional wisdom still believes that low interest rates are bound to lead an upturn in both the economy and the dollar. Most probably, a U.S. crisis will be triggered by the sudden capitulation of overconfident hopes in a U.S. economic recovery.

If the U.S. economy weakens again, as we think, both the dollar and U.S. financial markets — particularly the stocks — will suffer a sudden selling climax. The U.S. equity market is the last remaining global stock market bubble that has yet to burst. The fallout will surely drag down other international markets as well.

To investors, we can only redouble our long-standing warnings and recommendations. Basic common-sense fundamentals always rule financial markets over the long-run. Although long delayed, the long-run is now at the doorstep. More than ever, the best counsel is to pursue conservative, preservative, risk-adverse, high-quality investments that stand to benefit from the obvious long-term trends. For now, that continues to mean hard-currency bonds — the top-quality government bonds of Germany and Switzerland.



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